

N. PRIVATE SCHOOL UPDATE

by

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1. Introduction

While charter schools are the "new kids on the block," private schools have long been of concern to the Service. Actions relating to the Service's role in determining whether private schools qualify for recognition of exemption as organizations described in IRC 501(c)(3) have been discussed in most of the CPE texts published between 1979 and 1989. We have taken this opportunity to provide a historical review, an up to date discussion on the requirements of Rev. Proc. 75-50, 1975-2 C.B. 587, and a rundown on the various filing requirements that apply to private schools.

2. The Service's Role in Private Schools

In 1965, the Service stopped issuing rulings to private schools to consider the effect of racial discrimination on their exempt status. Following a lengthy study, the Service concluded, in 1967, that racially discriminatory private schools whose operations involved state action constituting a violation of the Constitution or federal laws were not entitled to tax-exempt status under IRC 501(c)(3). In 1970, the Service announced that, regardless of state involvement, racially discriminatory private schools did not qualify for exemption under IRC 501(c)(3). Only schools having a racially nondiscriminatory policy would be considered for tax exemption. See the 1980 CPE article on Private Schools for a more detailed description of actions taking place in the 1960's and 70's.

In arriving at the position that racially discriminatory private schools are not exempt, the Service relied on a clearly established federal policy against racial discrimination in education. This policy was first established by the Supreme Court in Brown v. Board of Education, 347 U.S. 483 (1954) and served as a precursor to the Civil Rights Act of 1964. Much litigation followed.

In 1970, a class action was filed to prevent the Service from recognizing exemption under IRC 501(c)(3) and from allowing IRC 170 deductions for contributions to private schools in Mississippi that discriminated against black students. In Green v. Connally, 330 F. Supp. 1150 (D. D.C. 1971), aff'd sub nom., Coit v. Green, 404 U.S. 997 (1971), and in the revised injunction orders issued on May 5 and June 2, 1980, the court placed the Service under a permanent injunction (still in effect) to deny tax exemption to racially discriminatory private schools in Mississippi. The Service must deny exemption to schools:

which have been determined in adversary or administrative proceedings to be

racially discriminatory; or were established or expanded at or about the time the public school districts in which they are located or which they serve were desegregating, and which cannot demonstrate that they do not racially discriminate in admissions, employment, scholarships, loan programs, athletics, and extracurricular programs.

These so-called “Paragraph (1) Schools” must demonstrate that they have adopted and published a nondiscriminatory policy. They must also provide certain statistical and other information to the Service to establish that they are operated in a nondiscriminatory manner. Most importantly, they must overcome an inference of discrimination against blacks. The injunction states:

The existence of conditions set forth in paragraph (1) herein raises an inference of present discrimination against blacks. Such inference may be overcome by evidence which clearly and convincingly reveals objective acts and declarations establishing that such is not proximately caused by such school's policies and practices. Such evidence might include, but is not limited to, proof of active and vigorous recruitment programs to secure black students or teachers, including students' grants in aid; or proof of meaningful public advertisements stressing the school's open admissions policy; or proof of meaningful communication between the school and black groups and black leaders within the community concerning the school's nondiscriminatory policies, and any other similar evidence calculated to show that the doors of the private school and all facilities and programs therein are indeed open to students or teachers of both the black and white races upon the same standard of admission or employment.

The injunction in Green applies only to Mississippi private schools.

The most significant judicial precedent in this area is Bob Jones University v. United States, 461 U.S. 574 (1983). This case specifically involved IRC 501(c)(3) and discrimination against black students. In this case, the Supreme Court emphatically affirmed the Service's position on racially discriminatory private schools. The Court stated that racial discrimination in education is contrary to public policy, and racially discriminatory educational institutions do not confer a benefit on the public that is within the meaning of "charitable" as that term is used in IRC 501(c)(3) or within the congressional intent underlying IRC 170 or 501(c)(3). The Court cited an unbroken line of cases as well as numerous federal legislative enactments and Executive Branch Executive Orders for its position that Bob Jones University violated a fundamental public policy. In determining whether schools are racially nondiscriminatory, the Service looks to cases such as Bob Jones University, as well as

Norwood v. Harrison, 382 F. Supp. 921 (N.D. Miss. 1974), on remand from the Supreme Court, 413 U.S. 455 (1973); Brumfield v. Dodd, 425 F. Supp. 528 (E.D. La. 1976); and Prince Edward School Foundation v. United States, 478 F. Supp. 107 (D. D.C. 1979), aff'd D.C. Cir. 6/30/80, cert. denied, 450 U.S. 944 (1981).

In reaching its conclusion, the Supreme Court acknowledged the sensitivity with which public policy matters are imbued:

We are bound to approach these questions with full awareness that determinations of public benefit and public policy are sensitive matters with serious implications for the institutions affected; a declaration that a given institution is not "charitable" should be made only where there can be no doubt that the activity involved is contrary to a fundamental public policy. Bob Jones University, 461 U.S. at 592.

In emphasizing the limited circumstances in which the Service and the courts may consider the effect of public policy, the Court stated: "We emphasize, however, that these sensitive determinations should be made only where there is no doubt that the organization's activities violate fundamental public policy." Bob Jones University, 461 U.S. at 598.

In the mid-1980's the Service extended the "inference and rebuttal" approach beyond Mississippi. The Service determined the clear intent of Rev. Proc. 75-50 was that the adoption and publication of a nondiscriminatory policy is a minimum requirement for private schools, and clear and specific factual evidence must be provided to affirmatively show that the school operates in a racially nondiscriminatory manner. Private schools seeking recognition of exempt status bear the burden of affirmatively establishing a bona fide operation consistent with a policy of nondiscrimination. Where a private school has a history of racial discrimination it must show, by objective evidence, that the lack of minority students is due to factors other than a continuation of its past policies. Facts, which the courts and the Service have indicated, are likely to be relevant in attempting to establish nondiscriminatory policies include, but are not limited to, active and vigorous recruitment of minority students and teachers, financial assistance to minority students, and effective communication of the policy to the minority population. See G.C.M.'s 39524 and 39525 (July 1, 1986) for a detailed description of the extension of the "inference and rebuttal" approach.

The Service's approach was affirmed in Calhoun Academy v. Commissioner, 94 T.C. 284 (1990). There, the Tax Court held that a private school failed to show that it was operated in good faith in accordance with a nondiscriminatory policy toward black students. The private school was formed at the time of public school desegregation and never enrolled a black student or employed a black teacher. The court concluded that the school did not qualify for exemption under IRC 501(c)(3).

Although public policy in the area of racial discrimination has evolved through the past four decades, not all issues have been settled, and new questions have been raised regarding discrimination against women and various ethnic groups. In light of the Supreme Court admonition in Bob Jones University, *supra*, the role of the Internal Revenue Service in the public policy arena remains somewhat limited. The Service may recognize the effect of public policy on exemption only in those situations where there is no doubt as to the fundamental public policy at issue.

Having recognized the fundamental public policy against racial discrimination, the Service, in Rev. Rul. 71-447, 1971-2 C.B. 230, defined a racially nondiscriminatory requirement standard. The standard requires that a school admit the students of any race to all rights, privileges, programs, and activities generally accorded or made available to students at the school and that the school not discriminate on the basis of race in the administration of its educational policies, scholarship programs, loan programs, and athletic or other school administered programs. Procedures for establishing a racially nondiscriminatory standard were set forth in Rev. Proc. 72-54, 1972-2 C.B. 834, which has been superseded by Rev. Proc. 75-50, 1975-2 C.B. 587. Rev. Proc. 75-50, together with the provisions contained therein, has not been revoked, modified, or superseded.

3. Revenue Procedure 75-50

Rev. Proc. 75-50 sets forth guidelines and recordkeeping requirements for determining whether private schools that are applying for recognition of exemption under IRC 501(c)(3), or wish to retain exemption under IRC 501(c)(3), have a racially nondiscriminatory policy as to students. A decision as to whether a school is following a racially nondiscriminatory policy will be made on the basis of all the facts and circumstances. Schools subject to the Court Order in Green, *supra*, must satisfy additional requirements discussed in the next section.

A. Organizational Requirements

Section 4.01 of Rev. Proc. 75-50 requires that a school include a statement in its charter, bylaws, or other governing instrument, or in a resolution of its governing body, that it has adopted a racially nondiscriminatory policy as to students and does not discriminate against applicants and students on the basis of race, color, and national or ethnic origin.

- (1) The resolution must be written.
- (2) The resolution may be stronger, but not weaker, than the example in section 3.01 of the Rev. Proc. The wording does not have to be exactly as stated in the Rev. Proc.
- (3) The resolution must be adopted by a majority of the governing body.
- (4) If the resolution is not in the charter, bylaws, or other governing instrument, an approved copy of the board minutes approving the resolution may be submitted to show that the policy has been adopted.

B. Publication Requirements

Section 4.03 requires the school to make its racially nondiscriminatory policy known to all segments of the general community served by the school. To satisfy this requirement, schools may publish a Notice of Nondiscriminatory Policy as to Students in a newspaper of general circulation that serves all racial segments of the community, or advertise the policy through the broadcast media. The school must also publish its nondiscriminatory policy in all brochures and catalogs dealing with admissions, programs, and scholarships.

(1) The Notice of Nondiscriminatory Policy

- Must be published at least once annually during the period of solicitation for students or, in the absence of a solicitation program, during the school's registration period.
- If the notice is published in a newspaper of general circulation, it must appear in a section that will be read by prospective students and their families. The notice should be published in the same newspaper(s) in which the school advertises to attract students.
- The notice must occupy at least three column inches (vertically or

horizontally) and be captioned in at least 12 point bold face type as a Notice of Nondiscriminatory Policy As To Students. The text must be printed in at least 8 point type. There may be some variations from the example in Rev. Proc. 75-50 as to print due to the newspaper's available font.

- The notice may be combined with an advertisement for enrollment. However, the notice must be captioned Notice of Nondiscriminatory Policy As To Students in at least 12 point bold face type, be at least three column inches, and printed in at least 8 point type. The notice within the advertisement should meet the requirements of section 4.03 as if it were standing alone.
- The school should be identified in the notice. If the name of the school appearing in its Articles of Incorporation and the name under which it operates are different, both should be identified in the notice.

(2) Publicity of Policy

Every school must include a statement of its racially nondiscriminatory policy in all of its brochures and catalogues dealing with student admissions, programs, and scholarships, as well as in other written advertising recruiting students.

- This statement should read as follows: The M school admits students of any race, color, and national or ethnic origin.

(3) Exceptions to Notice Requirement

While it is the Service practice to encourage all private schools to publish the Notice of Discriminatory Policy as to Students, Rev. Proc. 75-50, Section 4.032 provides the following exceptions:

- Church-related Schools

If for the preceding three years at least 75% of its students are members of the sponsoring religious denomination or unit, the school may make its racially nondiscriminatory policy known in church newsletters or newspapers the religious denomination utilizes in the communities from which the students are drawn. However, if the school advertises in

newspapers of general circulation during its enrollment or registration period, it must also publish its notice of racially nondiscriminatory policy in the same newspapers. See Reg. 1.6033-2(h) for an explanation of “affiliated with a church or convention of churches.”

- Schools Drawing Students From a Large Geographic Area

If the school draws a substantial percentage of its students nationwide, worldwide, or from one or more large geographic areas within the United States, and it provides evidence that it follows a racially nondiscriminatory policy, it may satisfy the publicity requirement by (i) including a statement of nondiscriminatory policy in all its brochures and catalogues dealing with student admissions, programs, and scholarships, and (ii) including reference to its racially nondiscriminatory policy in other written advertisements informing prospective students of its program.

Such a school may demonstrate that it follows a racially nondiscriminatory policy by showing that it currently enrolls a meaningful number of racial minority students, or that its promotional activities and recruiting efforts are reasonably designed to inform students of all racial segments in the general communities within the area of the availability of the school.

- Clearly Operates a School on a Racially Nondiscriminatory Basis

Based upon the facts and circumstances, a school that clearly operates on a racially nondiscriminatory basis may satisfy the publicity requirements by: (i) complying with section 4.02 of Rev. Proc. 75-50; (ii) by showing that it currently enrolls students of racial minority groups in meaningful numbers; and, (iii) by showing the school’s promotional activities and recruiting efforts are reasonably designed to inform students of all racial segments within the area of the availability of the school.

- Foreign Schools

Foreign schools are generally subject to the requirements of Rev. Proc. 75-50. Such schools may be excepted from compliance with certain parts of the procedure if they can show that compliance with that part of the procedure would be (i) harmful, or (ii) illegal under the laws of the country in which they are located, or (iii) impossible because local law forbids maintenance or collection of information necessary to comply. See G.C.M. 37867 (February 27, 1979).

For example: A school may be excused from certain recordkeeping requirements by showing that the prevailing law prohibits collection and/or maintenance of data regarding race, or other ethnic categorization of students and/or faculty.

- Public Schools under the Civil Rights Act

A public school is defined as one supported primarily by the government. Only private schools are subject to Rev. Proc. 75-50. Assistance in determining whether a given institution is a private or public school can be found in section 401(c) of the Civil Rights Act of 1964, 42 U.S.C. 2000c(c), which provides that the term “public school” means an elementary or secondary educational institution, provided that such public school is operated by a state, subdivision of a state, or governmental agency within a state, or operated wholly or predominantly from or through the use of governmental funds or property derived from a governmental source. Charter schools that are treated as public schools under state legislation are not subject to the requirements of Rev. Proc. 75-50 as long as they are operating under a contract with a government agency and are required to operate in a nondiscriminatory manner.

(4) Recordkeeping Requirements

Section 5 of the Rev. Proc. describes the information that must be submitted when applying for tax-exempt status. Section 7 explains that certain records must be maintained for a minimum period of three years beginning the year after compilation or acquisition. Such annual records include:

- Racial composition of the student body, faculty, and staff by academic year.
- Records to document that scholarships and financial assistance are awarded

on a racially nondiscriminatory basis.

- Copies of all brochures, catalogues, and advertising dealing with student admissions, programs, and scholarships.
- Copies of all materials used by or on behalf of the school to solicit contributions.

4. Mississippi Schools

The court in Green, supra, ordered specific guidelines and recordkeeping requirements for Mississippi private schools. The court's order varies from the guidelines and recordkeeping requirements set forth in Rev. Proc. 75-50 in that it contains certain additional requirements. Specifically, the injunction, as revised, requires the following:

- The school must adopt a policy and publish the fact that it has a racially nondiscriminatory policy as to students, meaning that it admits the students of any race to all the rights, privileges, programs and activities generally accorded or made available to students at that school. It must state specifically that it does not discriminate on the basis of race in the administration of educational policies, applications for admission, of scholarship and loan programs, and athletic and extra-curricular programs.
- The school must publicize this policy in a manner that is intended and reasonably effective to bring it to the attention of persons of student age (and their families) who are of minority groups, including all nonwhites. Specifically, but not exclusively, the school must-
 - (1) If it chooses to publicize this policy in printed notices, caption such notices in such a way to call attention to the notice, for example bold face headings, and to call attention to its nature as a notice of racially nondiscriminatory policy as to students; such printed notices of nondiscriminatory policy must be published every calendar quarter, including during the period of the school's solicitation for students for a period of three years in a newspaper of general circulation serving the area from which the school draws its student body; if the school chooses to publicize its policy through radio advertisements, the advertisements must be broadcast with sufficient frequency to be reasonably designed to reach the intended audience in the minority community. A school employing this method of publicizing its nondiscriminatory policy must supply the Service with the date and times of transmission; transcript of the announcement; and, both the

number of times the message was broadcast on a particular day and the number of times it was broadcast during the year;

- (2) Provide reference to its nondiscriminatory policy in its brochures and catalogues and also in any printed advertising which it uses as a means of informing applicants of its programs;
 - (3) Comply with all the other requirements of Rev. Proc. 75-50;
 - (4) Certify that it has made no statement and taken no action, qualifying or negating its published statements of nondiscriminatory policy as to students.
- The Service is also enjoined from approving or continuing the tax-exempt status under IRC 501(c)(3) unless such private school has supplied the Service on an annual basis for a period of three years with the information needed for the Service to determine whether the school has actually established a policy of nondiscrimination. The information required is:
 - (1) Racial composition, as of the pending academic year, and projected, so far as may be feasible, for the subsequent academic year, of -
 - a. Student body,
 - b. Applicants for admissions,
 - c. Faculty and administrative staff.
 - (2) Amounts of scholarship and loan funds, if any, awarded to students enrolled or seeking admission, and the racial composition of students who have received such awards. If any tuition due the school has been waived, the number of students, by race, granted such waiver during each school year must also be provided.
 - The yearly compilations of data should be supplied to the Internal Revenue Service, P.O. Box 2508, Cincinnati, Ohio 45201, Attn: Chief, EP/EO Division, by April 1 each year. Copies of the quarterly notices of nondiscriminatory policy must be submitted on an annual basis with the other information required by the court order. The beginning of the three year quarterly publication requirement, for the purposes of compliance with the 1980 Green orders, is the date of the ruling recognizing tax-exempt status. Initially, reports were sent to the Atlanta Key District, but upon centralization of the determination process a change was made to send the reports to Cincinnati.

5. Filing Requirements

Every organization described in IRC 501(c)(3) must file an annual information return [Form 990, Return of Organization Exempt from Income Tax, or Form 990-EZ, Short Form Return of Organization Exempt From Income Tax] if its gross receipts are normally over \$25,000 and it is not otherwise excepted from this requirement. Most schools fall in this category and must file. Excepted from the filing requirement are the following:

A. Church Schools

Churches, a convention or association of churches, or an integrated auxiliary of a church are excepted from the annual return filing requirement. A school below college level "affiliated" with a church or operated by a religious order falls within this exception and would not be required to file the annual information return. To be considered "affiliated," a school must be controlled by or associated with a church or a convention or associations of churches. For example, if a majority of the school's officers or directors is appointed by a specific church, the school would be considered controlled by that church. See Rev. Proc. 86-23, 1986-1 C.B. 564 and Reg. 1.6033-2(h) for additional information.

B. Governmental Units

Rev. Proc. 95-48, 1995-2 C.B. 418, provides relief from the annual filing requirement for organizations described as "governmental units" or "affiliates of a governmental unit." An "affiliate of a governmental unit" must have a ruling from the Service that (1) its income, derived from activities constituting the basis for its exemption under IRC 501(c), is excluded from gross income under IRC 115; (ii) be entitled to receive contributions under IRC 170(c)(1), on the basis that contributions to it are "for the use of" governmental units; or (iii) be a wholly owned instrumentality of a state or political subdivision for employment tax purposes.

An organization may be treated as an "affiliate of a governmental unit" in the absence of an IRS ruling if-

- It is either "operated, supervised, or controlled by" governmental units, or by organizations that are affiliates of governmental units, within the meaning of Reg. 1.509(a)-4(g)(1)(i). This relationship is established if the majority of the officers, directors, or trustees are appointed or elected by the governing body.
- It possesses two or more of the affiliation factors listed in section 4.03 of Rev. Proc.

95-48; and

- Its filing of Form 990 is not otherwise necessary to the efficient administration of the Internal Revenue Code.

Generally, schools that request to be excepted from the annual filing requirement as "affiliates of a governmental unit" are "public school districts." Public school districts do not have to file Forms 990 because they are under the control of a governmental unit and the school board is elected per local statute. Most charter schools do not satisfy the requirements of Rev. Proc. 95-48 because their boards are not publicly elected or appointed by the governing body.

C. Form 5578, Annual Certification of Racial Nondiscrimination for a Private School Exempt From Federal Income Tax

If an organization that operates, supervises, or controls a private school(s) [including a charter school] is required to file Form 990 or Form 990-EZ, it must certify that it is nondiscriminatory on Schedule A (Form 990). If an organization is excepted from filing Form 990, Form 5578 must be submitted to the Ogden Service Center. This form is used by exempt organizations that do not file Form 990.

D. Other Filing Requirements

Exempt schools must also file other returns and reports that may include, but are not limited to:

(1) Form 990-T, Exempt Organization Business Income Tax Return

Schools engaging in unrelated trade or business activities that result in gross income of \$1,000 or more must file a tax return on Form 990-T. The instructions on the return and the discussion in Publication 598, Tax on Unrelated Business Income of Exempt Organizations, provide assistance in determining when such a return needs to be filed and what information must be included.

(2) Employment Tax Forms

Publication 15, Circular E, Employer's Tax Guide, summarizes the responsibilities of an employer. Publication 15-A, Employer's Supplemental Tax Guide; and Form 941, Employer's Quarterly Federal Tax Return, provide the information needed by schools to meet their employment tax obligations.

(3) Form 8282, Donee Information Return

If a school receives a contribution for which a charitable deduction is allowed, and sells, exchanges, or otherwise disposes of the property within two years of its receipt, the school must file Form 8282.

(4) Information Provided to Donors

An exempt school must give a donor a disclosure statement for a quid pro quo contribution over \$75. The donor cannot deduct a charitable contribution of \$250 or more unless the donor has a written acknowledgment from the school. Publication 1771, Charitable Contributions-Substantiation and Disclosure Requirements; Publication 557, Tax-Exempt Status for Your Organization; and, Publication 526, Charitable Contributions, provide additional information.

(5) Form W-2G - Certain Gambling Winnings

Certain gaming transactions require the filing of Form W-2G and Form 1096. This may apply to a school if it conducts raffles or sells pull-tabs or lottery tickets to raise funds. Refer to Publication 3079, Gaming Publication for Tax-Exempt Organizations.